Fiduciary and Legal Considerations for Student Managed Investment Funds

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Student managed investment funds (SMIFs) are popular forms of experiential learning in business schools and finance departments. The investment management experience is a real world activity and the structure of the fund may also introduce real world fiduciary and legal responsibilities for students, faculty, and administrators. In this paper we review how the Uniform Prudent Management of Institutional Funds Act (UPMIF) and Investment Advisors Act of 1950 apply to common structures of student managed funds. We summarize our findings to suggest the best structure of a student managed fund depending on the source of funding and relevant requirements under the UPMIF and the Investment Advisors Act of 1940.
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Introduction

Student Managed Investment Funds (SMIFs) continue to grow as Universities recognize the many benefits of experiential learning through real-time investment management. The first known student managed fund was established at Gannon University in 1952. Since that time the number of universities supporting various forms of student managed funds increased dramatically. Lawrence (1994) outlines the early history of SMIF development since the inception of the Gannon fund. Neely and Cooley (2004) report that approximately 130 universities sponsor student managed funds, with the largest fund reaching five million dollars.


The overall experience with student managed funds reported in the literature is very positive. The programs not only offer unique learning opportunities but are also valuable for resume enhancement, school promotion, alumni networking, and involvement of practitioners with finance programs. Authors consistently conclude that the SMIF experience is very popular with students and with university administrators, providing important goodwill for finance
departments. SMIF programs are also considered to be very time intensive for students and their faculty advisors, requiring adequate credit for all participants.

In this paper we address dimensions of student managed funds that have not yet received much attention. Given the wide range of student and faculty roles and alternative sources of funding, the fiduciary and legal aspects of operating student-managed funds under different structures is an important consideration. Specifically, we examine the *Uniform Prudent Management of Institutional Funds Act* and the *Investment Advisors Act of 1940* to address the question whether different structures impose different degrees of liability for the students, their advisors, and the university.

**Funding Sources**

The start-up funds for a student managed fund tend to come from three different sources. Funds may be provided by a donor as a gift with the sole purpose of allowing students to make security selections and portfolio management decisions. The donor knows that students will make the investment decisions and the donor does not retain rights to the funds. Another source of funding is for the university to give a portion of the university endowment to be managed by the student fund managers. In this case donors to the endowment create a general fund under the control of a university official, normally a vice president of finance. The university official has the fiduciary responsibility for the fund. A third alternative source of funding may come from private sources where the donor retains rights to the funds. In this case the fund is more like an investment club or a form of a mutual fund. Each of the three different sources of funds presents a different set of legal and fiduciary requirements.

**Direct Gift**
Of the three sources of funding, the donation of funds as a gift directly to the SMIF for educational purposes is the best way to avoid potential liability. The donor knows the funds are to be managed by students and not professional investment advisors and the gift is for educational purposes. The donor does not retain rights to the fund and it is not part of the general endowment or any other form of “pooled funds” from donors giving to a general endowment fund. The donor needs to clearly specify any restrictions that might be placed on how the money should be invested. For example, a donor may designate that the fund invest in fixed income instruments only. The SMIF’s primary legal and fiduciary responsibility in this case is to follow the restrictions provided from the donor.

University Endowment

When SMIF funds are part of the university endowment, the *Uniform Prudent Management of Institutional Funds Act* will generally provide the legal and fiduciary standards to be followed by the fund. The *Uniform Prudent Management of Institutional Funds Act* (UPMIF) was proposed by The National Conference of Commissioners on Uniform State Laws (NCCUSL) at its 2006 annual meeting. The NCCUSL recommended the UPMIF for enactment by the legislatures of the various states to replace the Uniform Management of Institutional Funds Act (UMIFA), approved by NCCUSL in 1972.\(^1\) Gary (2007) provides an excellent review of the differences between UMIFA and UPMIFA. This uniform law is adopted state by state, and therefore the law may be slightly different in each state. UPMIFA has been enacted in 49 states since 2006 (see Figure 1). Only Pennsylvania has yet to pass the law.

The UPMIFA applies retroactively to the investment and the expenditure of all funds donated as endowments to, and held by, charitable institutions. The Supreme Courts of New Hampshire (Request of the Senate No. 6667, 113 N.H. 287, 306 A.2d 55 (1973)); Colorado (re
Estate of DeWitt, 54 P. 3d 849 (Colo. 2002)); and Minnesota (re Gardner's Trust, 266 Minn. 127, 132, 123 N.W. 2d 69, 73 (1963)) support the retroactive application of the Act. The UPMIF proposed a single standard of prudence for fund managers in charitable institutions, without regard to the organizational structure of the charitable institution. The NCCUSL intended for the UPMIF definition of institution to include governmental entities that hold funds for the purposes of “the relief of poverty, the advancement of education or religion, the promotion of health, the promotion of a governmental purpose, or any other purpose the achievement of which is beneficial to the community” (UPMIF Section 2, 1).

In the case of SMIFs, the standards would be the same for the endowment of a public university as for the endowment of a private university. The fiduciary and legal requirements for SMIFs investing money that is part of a university’s endowment are based on the UPMIF (a summary of the UPMIF standards is provided in the Appendix). The key requirements for student funds are summarized below:

1) Students involved with the management of the fund must follow normal standards of prudence and fiduciary care (UPMIF Section 3,b).

2) Students must consider general economic conditions, the effects of deflation or inflation, tax consequences of decisions, effect on the portfolio as a whole, the total return on the assets, other institutional resources, and institutional needs for fund distribution and preservation of capital when making investment decisions (UPMIF Section 3,e,1).

3) Investment decisions must be made in a portfolio context, not in isolation. The investment should be considered as part of an overall investment strategy, with risk and return goals suited to the fund and institution (UPMIF Section 3,e,2). Costs used
to support the student fund must be related to the purpose of the fund and be reasonable (UPMIF Section 4).

As a practical matter, there are several organizational issues that help keep a SMIF on track with the UPMIF requirements outlined above. For example, a requirement that student managers review the Chartered Financial Analysts’ (CFA) *Investment Policy Statement* (2010) provides an opportunity for students to learn the standards of prudence and fiduciary care (point #1 above) called for in the UPMIF.\(^2\) Table 1 provides an outline of the key components of the CFA’s Investment Policy guidelines.

A formal written Investment Policy for the fund should be structured to outline constraints imposed by institutional needs, resources, distribution and preservation of capital requirements. Requirements to consider general economic conditions, effects of deflation or inflation, total return goals, and tax consequences (point #2 above) may be met with an investment policy that addresses the top-down or bottom-up approach used by the fund. Point #3 above can be addressed with a written Investment Strategy as part of the fund’s Investment Policy with specified risk and return goals consistent with the institution. These written strategies offer learning opportunities for students who must organize and seek approval of a consistent approach to security selection, portfolio construction, and performance evaluation.\(^3\) Once approved, all written policies and procedures may be reviewed with new managers as part of an orientation process that keeps the fund on a consistent path as new managers join the program.\(^4\)

Finally, the fourth point above from the UPMIF requires a process for monitoring the cost of SMIF activities for both trading and for support of learning activities, such as field trips or data requirements. All costs may be budgeted and separated into costs of trading linked to
fund performance and costs linked to educational activities outside fund management. This is a good practice overall since students should track investment performance net of transaction costs to evaluate the consequences of investment decisions. A budget for costs to support the educational activities of the fund is important to sustain activities from year to year.

**Private Sources with an Ownership Claim**

Potential liability for investment decisions is highest for a fund based on private donations where the donor retains the rights to the funds. In this case the student managers are making investment decisions for other people and some expectation of an investment return exists. Both the donor and the fund managers should sign the IPS to make sure everyone is in agreement with respect to the expectations of performance. It is also important to take precautions to steer clear of registration requirements under the Investment Advisors Act of 1940. Funding from private sources with expectations of investment performance introduces a number of complications for student managed funds, which now must elevate the risk-return performance goal relative to the goal of “learning by doing.” For example, there is much less room for learning from mistakes.

**Academic Structure**

The role of students and the faculty “advisor” in a student-managed fund is slightly different depending on the academic structure for the fund. These academic structures tend to fall into one of the following four categories.

1. **Separate Course for Credit** - The fund is structured as a special class and students receive academic credit for successfully completing the course. Faculty advisors are performing as teachers in regularly scheduled class.
2. **Fund Combined with Existing Course** - The fund is managed as part of an existing course in the finance curriculum, normally an investment course. Again, faculty advisors are performing as teachers in a regularly scheduled class.

3. **Extracurricular Activity** - The fund is managed as an extra-curricular activity similar to a club. Students do not receive academic credit for the course and faculty members serve as advisors of an extra-curricular activity.

4. **Student Compensation for Fund Management** - The fund is an extra-curricular activity and students are compensated for their participation. Faculty members receive either some form of compensation or serve as advisors of an extra-curricular activity.

The key question in each of these structures is whether or not students and/or faculty are required to register as investment advisors. Under the Investment Advisers Act of 1940 and the investment adviser laws of the various states, the definition of “investment advisor” is pretty uniform (Investment Advisor Act of 1940, Section 202 (a) 11). An investment advisor is a person who for compensation engages in the business of providing advice as to the value of securities or the advisability of buying or selling them, or issuing reports on or analyses about them. The key wording here is the term “for compensation”. If students and/or faculty are not compensated for their work on the fund they are not considered to be investment advisors. This provision makes the first three organizational structures free of registration requirements for students. However, if students and/or faculty are compensated in any way, such as stipend for managing the fund in the summer or over holidays, they may be required to register with the
Securities and Exchange Commission and may also be subject to state regulation of investment advisors.

The role of the faculty member in each of the organizational structures should be limited to “teaching.” Teachers are excluded from the definition of investment advisors as long as the activity in which they are engaged is solely incidental to the practice of their profession. Teaching is not confined to teaching a course for credit. Supervision of extra-curricular activities is commonly part of the teaching profession and should not make a difference in the application of the definition of investment advisor. A key point in the academic structure is that the central purpose of student managed funds must be the educational experience. Faculty roles should be consistent with their profession as teachers and students should participate for the educational experience. It is not necessary for the fund to be structured as a course for credit, but a fund structured as a course for credit clearly fits appropriate definitions of faculty as teachers and students as students.

Responsibility for Decisions in the Fund

There are three common ways student managed funds use students in the decision process. Most funds allow students to make stock picks and/or asset allocation decisions, but with varying degrees of supervision by faculty or university officials. The three most common ways of giving students responsibility in managing a live portfolio are outlined below.

1. The students are responsible for all management decisions, consistent with the investment policy restrictions.
2. The students are responsible for all management decisions, but faculty or university officials have veto powers over the decisions.
3. The students make recommendations to the professor and/or an advisory board. The professor and/or advisory board is responsible for making the final decision. Again, the role of faculty advisor or course instructor needs to be clearly specified with respect to UPMIF. If the students are using the assets for the educational purpose of gaining experience managing an investment fund, the faculty member may be restricted from using her special skills or expertise in the management of the assets. However, if the faculty member is not so restricted and makes investment decisions, she could be considered as having special skills or expertise under the Act. The fund needs to spell out the faculty member’s duties, responsibilities, and restrictions very clearly and carefully. If a SMIF uses the third structure where additional compensation is awarded to faculty, it is harder to define faculty activity with the fund to be part of the duties of their profession as teachers. Figure 2 provides a brief summary of the legal and fiduciary requirements for different combinations of the source of funds, academic structure and decision-making.

Conclusion

Student managed investment funds are now becoming a common part of a finance curriculum. These funds have different structures from school to school based on different combinations of ways of raising the money to be managed, structuring the academic experience, and making the investment decisions. Based on our review of the different structures and relevant legal requirements we believe there is a combination of structures that minimize potential legal and fiduciary questions. The safest approach to creating a student-managed fund is to find a donor willing to give funds for the sole purpose of student investment management. The donor should not retain rights to the funds or have expectations of professional investment management.
The fund should be structured to provide academic credit with a regular class format and a faculty member teaching the course. This academic structure clearly makes the role of the faculty member in the fund consistent with the faculty member’s profession. Course credit also makes it clear that the fund is for educational purposes and students are making decisions as part of an experiential learning experience. Finally, all decisions should be made by students and faculty should supervise only to the point of exercising veto power or keeping the fund within agreed-upon parameters specified in the investment policy. Summer stipends or any other form of compensation to students or advisors linked to participation in the student-managed fund should be prohibited.

Our suggested approach to establishing a student managed fund is designed to steer clear of potential problems with students or faculty serving as investment advisors under commonly accepted definitions. While these definitions of investment advisors tend to be uniform across states it is a good idea to check with state securities regulation departments for rulings on any forms of registration requirements that might be specific to that state.
Figure 1. UPMIFA Enactment Status as of July 25, 2012

Source: http://www.upmifa.org
Table 1. The CFA’s Suggested Components of an Investment Policy *

1. Factual Data:
   - Where the assets are held
   - Amount of the assets under management
   - Identification of trustees or interested parties to the account

2. Client (source of funding):
   - Discussion and review of the client’s investment objectives
   - Investment time horizon
   - Any anticipated withdrawals or deposits
   - Need for reserves or liquidity
   - Attitudes regarding tolerance for risk and volatility

3. Constraints and Restrictions on Assets:
   - Liquidity and marketability requirements
   - Diversification concentrations
   - Advisor’s investment strategy (including tax management if applicable)
   - Locations of assets by account type (taxable versus tax-deferred)
   - How client accounts that are not being managed (if any) will be handled
   - Transaction prohibitions

4. Securities to be Included in Investments:
   - Types of securities and asset classes to be included or excluded in the portfolio
   - Basic allocation among asset categories and the variance (rebalancing) limits for this allocation.

5. Controls:
   - Monitoring and control procedures and responsibilities of each party.


Notes:

* It is important to make sure that there is nothing in the IPS that the student managers, faculty advisors, or provider of funds cannot implement or verify.
Table 2. Summary of Fiduciary and Legal Requirements relative to Sources of Funding, Academic Structure, and Decision

<table>
<thead>
<tr>
<th>Source of Funds</th>
<th>Academic Structure</th>
<th>Investment Decision Process</th>
<th>Fiduciary and Legal Requirements</th>
</tr>
</thead>
<tbody>
<tr>
<td>Direct Gift</td>
<td>Scheduled class or extra-curricular activity</td>
<td>Any</td>
<td>Meet all specific requirements established by the donor</td>
</tr>
<tr>
<td>University Endowment</td>
<td>Scheduled class or extra-curricular activity</td>
<td>Different decision-making may impact whether the special skill and knowledge of the faculty member must be used.</td>
<td>UPMIF</td>
</tr>
<tr>
<td>Private Sources with ownership claim</td>
<td>Scheduled class or extra-curricular activity</td>
<td>Any</td>
<td>The Investment Advisor Act of 1940</td>
</tr>
</tbody>
</table>
Endnotes


3. A written investment policy helps minimize legal liability when someone invests other people’s money and is a best practice for all investment managers. Because of frequent manager turnover in a SMIF, the creation of the IPS is a critical first step in organizing a program. The IPS establishes and documents ongoing policies for future decision-making and helps provide consistency across different managers.

4. A number of user friendly examples and templates are available to help students and advisors create the IPS. For example, see Morningstar’s “Creating your Investment Policy Statement” at www.morningstar.com/classroom2/course.asp?docid=course108.

5. Whether or not a person is considered to be an investment adviser under the IAA generally depends on three criteria: the type of advice offered, the method of compensation, and whether or not a significant portion of the "adviser's" income comes from proffering investment advice (Investment Advisor Act of 1940, sec. 202, (a), 11, full text available at www.sec.gov/about/laws/iaa40.pdf).
References


Appendix: Summary of UPMIF Standards
(For full text see http://www.law.upenn.edu/bll/archives/ulc/umoifa/2006final_act.htm)

A. Donor intent as expressed in a gift instrument should be followed. Restrictions can be released or modified if:

a. The donor consents for the record;

b. The court can modify or release a restriction if the restriction;
   i. Is impracticable
   ii. Is wasteful
   iii. If it impairs management or investments
   iv. If, under circumstances unanticipated by the donor, the purposes of the fund will be enhanced
   v. If the restriction becomes unlawful, impracticable, or impossible to achieve.

c. The institution can modify or release a restriction upon notification of the Attorney General if the institution has found the restriction is unlawful, impracticable, impossible to achieve, or wasteful if:
   i. The restricted fund’s total value is less than $25,000
   ii. And, more than twenty years have passed since the donation,
   iii. And, the institution uses the assets in a manner consistent with the donation’s charitable purposes.

B. Good faith and prudence (with the care an ordinarily prudent person in a like position would exercise under similar circumstances) is required of any person managing or investing an institutional fund.

C. While managing an institutional fund, managers:

a. May incur only appropriate and reasonable costs relative to the assets, institutional purposes, and skills available.

b. Verify facts relevant to the management and investment of the funds.

D. Funds can be pooled for purposes of investment and management.

E. Except where otherwise specified by the donor:

a. Several enumerated factors must be considered;
   i. General economic conditions
   ii. Effects of deflation or inflation
   iii. Tax consequences of decisions
   iv. Effect on the portfolio as a whole
   v. The total return on the assets
vi. Other institutional resources

vii. Institutional needs for
   1. Funds for distributions
   2. Preservation of capital

viii. Special relationship to the charitable purposes of the institution (a lung cancer charity would probably not invest in a cigarette company).

b. Investment decisions must be made in a portfolio context, not in isolation. The investment should be considered as part of an overall investment strategy, with risk and return goals suited to the fund and institution. There are no restrictions on investing in any kind of asset under the Act.

c. Diversification is required unless special circumstances show that the institution is better served without diversification.

d. Decisions are to be carried out within a reasonable time.

e. A person having special skills or expertise, or who represents to having special skills or expertise, has a duty to use those skills or expertise in managing and investing the funds.